MEMORANDUM

DATE: August 25, 2008

David Cormier

TO: The Honorable Mayor and Council Members

FROM: David Cormier
Interim Finance Director

SUBJECT: Preliminary/Unaudited FY 2007-08 Financial Results - Focus on the City's General Fund and Reserves

This memorandum and its attachment have been prepared to provide you with financial information on the fiscal year just ended (June 30, 2008), with a focus on the General Fund revenues, expenditures, and unreserved/undesignated fund balance. The City's General Fund began the fiscal year with unrestricted/undesignated reserves of $43.7 million. A preliminary look at year-end results calculates reserves at $31.9 million, an $11.8 million decrease. The attached schedule provides a look at the calculation and the factors contributing to the decrease. As a percentage of General Fund expenditures, reserves decreased from 10.1% at the beginning of the fiscal year to 7.2% at the year's end.

Revenues were the major factor in the decline in unrestricted reserves. The revenue landscape, especially that related to sales tax receipts, has shifted significantly since the City's FY 2007-08 budget was developed in the spring of 2007. Based on available March 2008 data, the Finance Department had forecasted General Fund revenues to be approximately $14.7 million below the FY 2007-08 adopted budget levels. However, the local and state economy continued to be sluggish over the last quarter. Revenues, particularly sales tax revenues (City and State shared), continued to fall below projections and ended the year $20.6 million below related budgeted amounts.

It is important to note that the City's reserves have done what they are intended to do: *provide protection/resources during periods of financial instability, thereby avoiding wide fluctuations in the services provided to our community*. The existing reserves enabled the City's FY 2008 programs and operations to continue by managing vacancies without reducing staffing levels. The current financial environment serves to underscore the benefit reserves provide, the need to both *rebuild* our reserves to policy levels once economic growth returns, and to *safeguard* them once they have been re-established.

The remainder of this memorandum provides additional insight into the factors resulting in the reserve reduction.

Background

A City's unreserved fund balance is a measure of the financial resources available for unexpected/unanticipated spending. Commonly referred to as a "rainy day fund", it provides protection in times of economic downturn, and provides additional comfort to purchasers of the City's general obligation bonds. Rating agencies carefully monitor a government's unreserved fund balance levels when evaluating creditworthiness[1]. The Governmental Finance Officers Association (GFOA) recommends unreserved fund balance targets of 5% -15% of annual expenditures, but stresses that a City's reserve target level should consider the unique situation of each government.

In 2007, the Mayor and Council increased the City's reserve target from 7.5% to 10% of General Fund expenditures. During the period FY 2002-03 to FY 2006-07, reserves grew from less than 1% to more than 10%, or to $43.7 million; the result of both economic growth and by intentionally not using reserves for recurring costs.

The yearly change to the General Fund unreserved/undesignated fund balance is the amount by which *revenues exceed or fall short of expenditures/transfers*, adjusted by any changes to the fund's reserved or designated balances. Simply put, when General Fund revenues fall short of budget projections *and* expenditures/transfers remain at the budgeted level, the unreserved fund balance is utilized to the level of the revenue shortfall.

FY 2007-08 Revenue Results

The General Fund's revenues totaled $474.5 million, $20.6 million below the related FY 2007-08 budgeted levels.

The City's General Fund has three main tax-related revenues that together comprise over 70% of the fund's revenues:

- the City's business privilege (sales) tax,
- the shared State sales tax, and
- urban revenue sharing (State income taxes).

At the national, state, and local levels, those governments relying heavily on sales tax revenues were deeply affected in FY 2008. Sales taxes are a direct reflection of the economy, indicating how much people are buying in the way of taxable items. The economy struggled in the last year and Tucson's sales related revenues reflected that downturn.

While the City's allocation of urban revenue sharing met projections[2], the City's business privilege taxes and shared State sales tax receipts were significantly below the adopted budget level, $16.6 million and $5.3 million, respectively. These revenues were approximately 3% lower than FY 2006-07 revenues.

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[1] "Fund balance is a measure of an issuer's financial flexibility to meet essential services during periods of limited liquidity. Standard & Poor's considers an adequate fund balance to be a credit strength." - Standard and Poor's Public Finance Criteria manual.

[2] State income taxes are the source of State Revenue Sharing and are distributed to cities two years after collection by the State. This revenue will reflect the downturn in the economy in FY 2010 and beyond.

FY 2007-2008 Expenditure/Transfer Results

General Fund Expenditures

General Fund departmental expenditures for FY 2007-08 totaled $452.6 million, or $700,000 over the related budget. This reflects the net of the City's cost containment measures that began in mid-FY 2007-08 and various unbudgeted outlays.

Elements	Amount in millions
Cost containment efforts by Departments:	
Personnel savings *(vacancy management):*	**$ 6.1**
Capital Outlay	**1.1**
Miscellaneous other	**.3**
Total savings	**7.5**
Increased costs:	
Increased fuel costs	**(2.5)**
Retirement payouts (including end-of-service incentives)	**(2.5)**
Increased ADA improvement costs ($1.0 million)	**(1.0)**
Increased Metro Convention/Visitors Bureau	**(.5)**
Increased Retiree medical costs	**(.5)**
Increased Library support costs	**(.5)**
Increased Jail Board costs	**(.4)**
Increased Animal Care costs	**(.3)**
Total increased costs	**(8.2)**
Net savings	**$ (.7)**

General Fund Subsidies (Transfers to Other Funds)

The General Fund provided $44.5 million in subsidies to three City funds during FY 2007-08, two of which exceeded the budgeted amounts.

Fund	Transfer Amount	Over Budget
Mass Transit Fund	$36.3 million	$1.0 million
Convention Center	7.0 million	.3 million
ParkWise	1.2 million	0 million
Total Transfers	**$44.5 million**	**$ 1.3 million**

Factors contributing to the increases in the transfer/subsidies were:

Mass Transit Fund — Increased fuel costs ($1.3 million)[3] and the establishment of a reserve for inventory[4] within the Mass Transit Fund ($2.9 million) were the main factors in the increased subsidy to Mass Transit. Partially offsetting these increases were surpluses in various other line items ($1.4 million) and the reduced requirement for General Fund support of Transit capital projects (grant match) of $1.8 million.

[3] Net of CNG rebate credit of $923,000.

[4] FY 2008 included a large reserve change adjustment relating to Sun Tran/Van Tran inventories. GAAP principles require that fund balances provide a reserve for inventories since inventory purchases used cash resources and inventory consumption will be a future expenditure. Recognition of this reserve requirement should have been made in prior years. Since that did not occur, an adjustment for the full inventory balance of approximately $2.9 million will be made in FY 2008. Future fiscal year inventory adjustments will only reflect the incremental year-to-year changes in the inventory balance.

Convention Center The Convention Center increase was due to revenues, primarily rent, parking fees, and food/beverage sales being lower than budgeted.

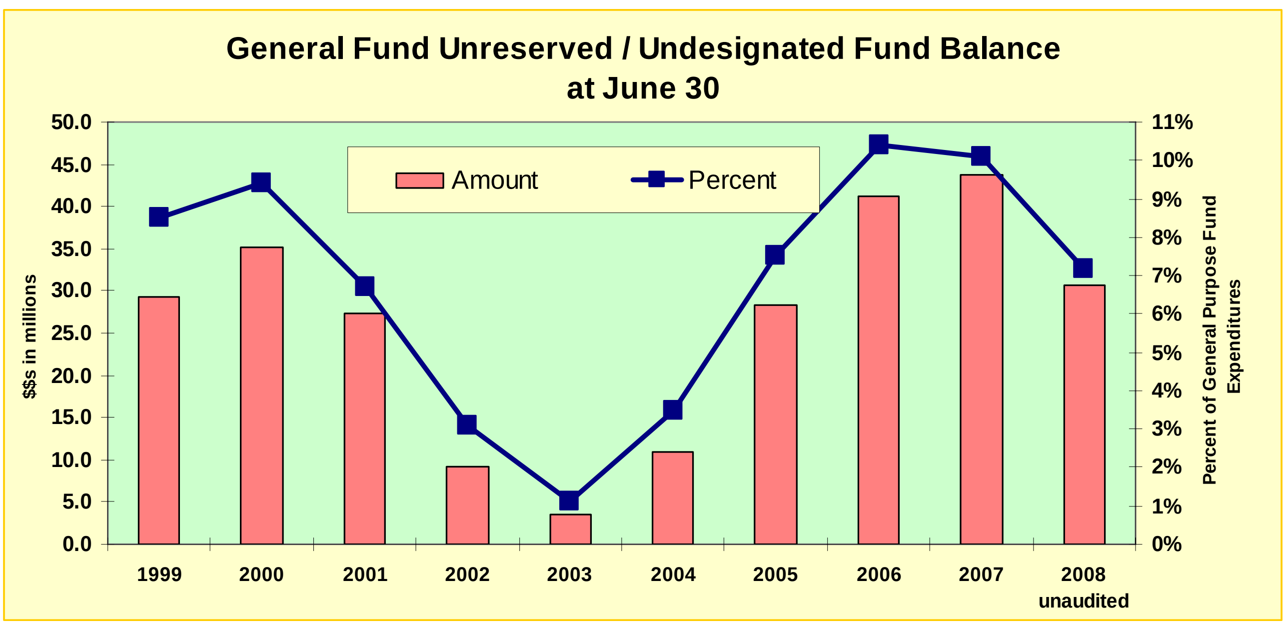
FY 2007-2008 Reserve/Designation Changes:

During FY 2007-08, the General Fund's restricted/designated reserves decreased by $10.8 million and the unreserved fund balance increased by a like amount. The *major* contributors to the reduction were the FY 2007-08 payments received by the General Fund on its long-term loan receivables ($4.4 million) and the decision to eliminate reserve designations ($7.3 million).[5] Partially offsetting these decreases were net increases in other reserves of $.9 million.

General Fund Unreserved Fund Balance – 1999 through 2008:

Because of the significant shortfall in revenues, the more modest restricted reserve/designation reductions, and net expenditures approximating budget levels, the General Fund's June 30, 2008 unreserved fund balance declined to $31.9 million, or 7.2% of General Fund Expenditures.

The following graph depicts the General Fund unreserved fund balance for the last 10 years.



Summary:

FY 2007-08 was a challenging financial year for the City. In his FY 2008-09 budget transmittal letter, the City Manager wrote: "Maintaining the reserve at 10% during this economic slowdown will be a challenge."

[5] Designation of reserves was a discretionary practice.

As indicated in the *Background* section above, a city's reserves serve to firm up its credit ratings. The City will soon be entering the market to sell approximately $33 million in general city certificates of participation. While rating agencies are keenly aware of the revenue shortfalls affecting many municipalities and their reserves, they will focus on what steps the City is taking to mitigate future erosion of reserves, and the action plans being developed to rebuild reserves over future years.

In the near future, you will receive the first look at the current fiscal year's revenue and expenditure projections, including the individual departmental expenditure reduction plans, and any anticipated impacts on reserves. The City Manager's Office will be working with all City departments to develop and implement additional cost reduction plans and other measures to minimize additional reductions to the City's reserves.

If you have any questions, or require additional information about FY 2007-08 and year-end results, please contact me at 791-4893.

DC:dc

Attachment

PRELIMINARY / UNAUDITED

GENERAL FUND RESERVES (Undesignated Fund Balance)

$$$s in Millions

Year End Results

Balance @ July 1, 2007		**$**	**43.7**
FY 2008 Revenues			**474.5**
FY 2008 Expenditures [1]			**(452.6)**
FY 2008 Transfers to Other Funds:			
Mass Transit	(36.3)		
Convention Center	(7.0)		
Parkwise	(1.2)		
Total Transfers to Other Funds			**(44.5)**
Changes in Reserves/Designations			
Reserve for Advances/Deposits	4.6		
Other Reserves	(1.1)		
Eliminate Designations	7.3		
			10.8
Balance @ June 30, 2008		**$**	**31.9**

Net Decrease to Reserves
(change from beginning to ending balance) **(11.8)**

How it Happened

Revenue Shortfall		**(20.6)**
Reduced Spending		
Departmental Reduction Efforts	7.5	
Increased Costs	(8.2)	
Net Reduction		**(0.7)**
Increased Transfers over Budget		
Mass Transit	(1.0)	
Convention Center	(0.3)	
		(1.3)
Reserve/designation changes (increase to reserve)		**10.8**
Net Decrease to Reserves		**(11.8)**

(1) Includes expenditures of the Public Safety Academy Fund; combined with with the General Fund as of July 1, 2008.